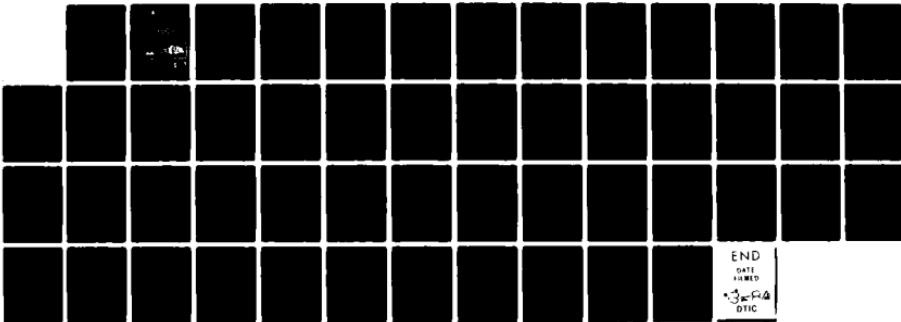


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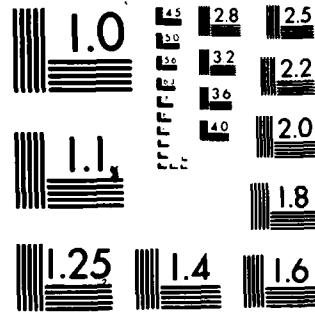
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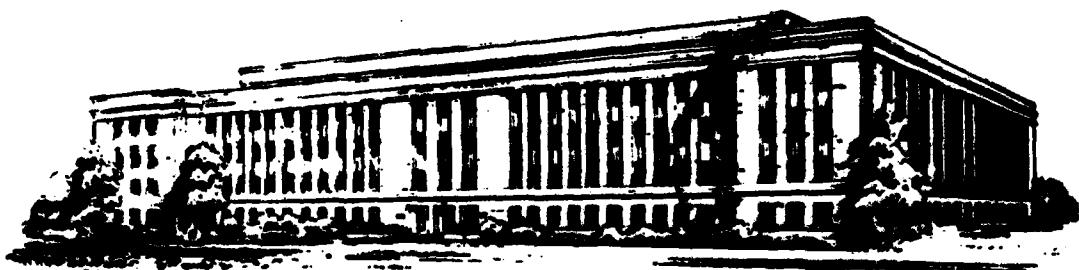


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**MOBILIZATION AND DEFENSE MANAGEMENT  
TECHNICAL REPORTS SERIES**

**PERFORMANCE REQUIREMENTS: THE NEW  
PROTECTIONISM AND ITS IMPACT  
ON DEFENSE TRADE**



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THE INDUSTRIAL COLLEGE OF THE ARMED FORCES  
NATIONAL DEFENSE UNIVERSITY

MOBILIZATION STUDIES PROGRAM REPORT

PERFORMANCE REQUIREMENTS:

The New Protectionism and Its Impact on Defense Trade

by

WILLIAM H. CAVITT  
U.S. Department of Commerce

A RESEARCH REPORT SUBMITTED TO THE FACULTY  
IN  
FULFILLMENT OF THE RESEARCH REQUIREMENT

THE INDUSTRIAL COLLEGE OF THE ARMED FORCES

MAY 1983

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**ABSTRACT OF STUDENT RESEARCH REPORT**  
**INDUSTRIAL COLLEGE OF THE ARMED FORCES**

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The New Protectionism and Its  
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**ABSTRACT**

Problem Statement: This paper investigates the role and impact of performance requirements on defense trade. Four aspects were considered: (1) the definition and incidence of performance requirements; (2) an automotive industry case study to measure the impact of performance requirements; (3) an electronics industry case study to determine the relevance of performance requirements to defense electronics and to draw inferences for the relevance to defense trade generally; and (4) the President's 1982 initiative on NATO co-production as a possible partial solution to performance requirements.

Conclusions:

1. Trade-related performance requirements distort international trade and investment patterns. The incidence of performance requirements is wide-spread, affects both commercial and defense trade in many industries, is common among both developed and developing countries, and is growing.
2. Defense trade generally and defense electronics trade in particular are seriously impacted by performance requirements to the detriment of U.S. export sales.
3. The President's 1982 offer to negotiate a multilateral framework to expand existing NATO co-production arrangements to provide open competitive bidding for defense contracts could contribute significantly to NATO cohesion and effectiveness, and render performance requirements moot in the process.

Recommendations:

1. The U.S. should make bilateral representations and use the NATO committees to convince its allies that the U.S. proposal is both genuine and viable.
2. Initial U.S. efforts should be modelled on the GATT Government Procurement Agreement, modified as necessary to provide for the concept of co-production and for the protection of national security interests.
3. Ways should be found to provide parallel negotiations with Japan.

THIS ABSTRACT IS UNCLASSIFIED

## EXECUTIVE SUMMARY

At the Western Economic Summit in Ottawa, Canada in 1981, the President of the United States put forth his "Trade Agenda for the 1980's" and sought the support of the leaders of the major western economic powers for a continuation of the trade liberalization process then lately successful with the conclusion of the Tokyo Round. Performance requirements were principal among the measures on that agenda which the President insisted had to be brought under control.

Performance requirements are measures imposed by host governments which require direct foreign investors to meet specific economic, social or political objectives in exchange for the provision of financial incentives, access to local markets and access to lucrative government procurement contracts. The most common performance requirements are local production, minimum export requirements, import restrictions, and minimum local labor and materiel content requirements.

The U.S. contends that performance requirements constitute unfair burdens placed on foreign investors which distort international trade and investment patterns, erode U.S. competitiveness and result in the export of U.S. jobs.

This study tested these assertions and found them largely to be true with respect to the automotive and electronics industries and by implication to defense trade generally. From the evidence available from other studies and from extensive interviews conducted in the course of this study, performance requirements were shown to be a significant factor which business executives must consider in bidding for foreign government procurements of defense systems.

Most electronics industry executives interviewed stated unequivocally that they could not sell in NATO and other countries unless they met various performance requirements. Some U.S. firms acknowledged that they had withdrawn from attempts to make defense sales in particular markets because the performance requirements were considered to be too onerous. Many electronics industry executives also acknowledged the charges of the AFL-CIO and others that performance requirements do indeed result in the export of U.S. production and job opportunities. However, these are usually new opportunities arising from increased foreign sales rather than the export of existing U.S. jobs.

The relationship between NATO co-production arrangements and performance requirements was explored. It was found that the NATO countries extensively utilize performance requirements in attempts to hold the line against massive military trade deficits with the U.S. However, where bilateral co-production arrangements exist pursuant to Memoranda of Understanding (MOUs), performance requirements are rendered moot. The President's 1982 offer to negotiate the expansion of existing bilateral co-production arrangements into a multilateral framework was examined to determine its relevance to performance requirements. It was found that the successful conclusion of such a negotiation could lead to greater NATO cohesion and effectiveness, while opening up defense systems procurement to freer trade.

On the basis of these conclusions, it was recommended that the U.S. pursue bilateral representations and use the NATO committees to convince our allies that the U.S. offer is genuine and viable. Initial NATO reactions to the U.S. proposal were reserved and negative, reflecting distrust of U.S. motives and disbelief in U.S. ability to deliver in the face of domestic protectionist pressures on the Congress. Those beliefs must be dispelled before much progress can be made.

It was further recommended that the GATT Government Procurement Agreement be examined to determine if it could serve as a model for a NATO agreement on defense systems procurement. Initial U.S. negotiating efforts should be focused here because of the many years of negotiations--some of it on defense trade--already invested in the GATT agreement. Therefore, it might provide a significant short-cut for progress on a NATO agreement.

Finally, it was recommended that parallel discussions be pursued with Japan in hopes of being able to make progress in that theatre as well as in Europe. Only by involving non-NATO countries early and often is there hope for further trade expansion into other largely closed foreign government procurement markets for defense systems.

## OVERVIEW

### Statement of the Problem

At the Western Economic Summit in Ottawa, Canada in 1981, the President of the United States put forth his "Trade Agenda for the 1980's" and sought the support of the leaders of the major western economic powers for a continuation of the trade liberalization process then lately successful with the conclusion of the Tokyo Round. Performance requirements were principal among the measures on that agenda which the President insisted had to be brought under control.

Performance requirements are measures imposed by host governments which require direct foreign investors to meet specific economic, social or political objectives in exchange for the provision of financial incentives, access to local markets and access to lucrative government procurement contracts. These requirements include stipulations regarding production, employment, and importing and exporting practices.<sup>1/</sup> The most common performance requirements, are local production, minimum

export requirements, import restrictions, minimum local labor and materiel content requirements, technology transfer, maximum equity participation in local business activities, and capital flow limitations, usually on profits to be repatriated to U.S. parent firms.

The United States contends that performance requirements constitute unfair burdens placed on foreign investors which distort international trade and investment patterns, erode U.S. competitiveness, and result in the export of U.S. jobs.

#### Scope of this Study

This study will address performance requirements as they relate to defense trade. By way of introduction and overview of the issue, performance requirements will first be discussed in historical perspective relative to previous international trade liberalization efforts. Second, the incidence of performance requirements will be explored, seeking to get some notion of the extent and severity of the problem on a macro-economic level. Third, the complexity of performance requirements will be explored by considering such issues as transparency, linkages and targetting.

With this overview of the issue, a case study of the performance requirements contained in the Mexican Automotive Decree will be considered. The automotive case study has little to do with defense trade, but it is the one industry where empirical evidence has been developed to demonstrate the adverse consequences of performance requirements. Therefore, the automotive case study provides a convenient test bed on which to evaluate whether performance requirements as a generic issue warrants analysis with respect to defense trade.

Next, a case study of the electronics industry--both commercial and military--will be considered with particular emphasis on whether performance requirements adversely affect trade in defense systems. Electronics is a particularly good case study because this industry can be considered illustrative of defense trade generally because of the large electronics component in most defense systems. Since little analysis and even less empirical data exists in this area, these views of the electronics industry necessarily must be anecdotal and indicative only.

With this perspective, the President's 1982 initiative on NATO co-production will be examined to assess whether it may provide a partial solution to performance requirements

as they may apply to defense trade. Finally, the conclusions developed in the course of this study will be summarized and some recommendations on future policy directions proffered.

#### Historical Perspective

Historically, governments have relied on tariffs and quantitative restrictions to protect domestic producers and infant industries from import competition. In the latter half of the twentieth century, largely as a result of successive rounds of multilateral trade negotiations conducted under the auspices of the General Agreement on Tariffs and Trade (GATT), the existence and importance of tariffs and quantitative restrictions gradually were reduced to the point where today such measures play only a minor role in influencing trade and investment among the industrialized countries.

By their nature, tariffs and quantitative restrictions are transparent and quantifiable, thereby lending themselves to quantitative analysis and negotiation. During the decades that such devices were used to influence trade and investment, a trade policy world of relative clarity existed. However, at the very time that international efforts were underway to reduce tariffs and quantitative

restrictions, governments were becoming increasingly creative at devising new non-tariff measures to replace those being negotiated away. A world of relative clarity was giving way to one of much greater ambiguity.

This trend toward putting new non-tariff protectionist devices in place received its first significant international attention during the Kennedy Round of Multilateral Trade Negotiations in the 1960's, but little progress was made. Non-tariff barriers to trade were attacked with vigor during the Tokyo Round of negotiations in the 1970's with considerable success. Several international codes-of-conduct were negotiated covering such trade-distorting practices as subsidies, dumping, discriminatory government procurement practices, and standards. These codes apply almost entirely to commercial transactions. Most defense trade was explicitly excluded from the scope of such agreements.

As in the past, however, even as the protective nature or aspects of these measures were being brought under greater international discipline, yet more sophisticated measures were being devised to protect national interests from the full brunt of international competition. Performance requirements are among those measures and have been described as the cutting edge of the new protectionism.

### Incidence of Performance Requirements

The U.S. Department of Commerce's Bureau of Economic Analysis undertook a study entitled Benchmark Survey of U.S. Direct Investment Abroad-1977. That survey covered 3,540 U.S. non-bank parent companies with 23,641 non-bank foreign affiliates. Inasmuch as reporting was mandatory, virtually the entire universe of U.S. direct foreign investment was covered. The firms were required to report, inter alia, whether they had received any incentives and whether they had to accept performance requirements as part of the price for securing foreign government approval for U.S. direct investment.

Of the many types of performance requirements identified in this and later, less comprehensive surveys, four stand out as the most prevalent: minimum export requirements, import restrictions, minimum local labor content requirements and minimum local materiel content requirements. Overall, 3,240 affiliates out of the 23,641 surveyed (14%) reported that they were subject to at least one performance requirement. Both industrialized and developing countries impose such requirements. However, about 70% of the incidence of performance requirements occurred in developing countries and only 30% in the industrialized countries.<sup>2/</sup>

The 1977 Benchmark Survey also measured the incidence of performance requirements by industry. The affiliates in the mining and transportation sectors reported the highest incidence of performance requirements at 27 percent. Other industries significantly effected were electrical machinery and food manufacturing (each, 21%), chemicals and allied products (19%), primary and fabricated metals (18%), petroleum (16%) and non-electrical machinery (14%).<sup>3/</sup> It is noteworthy that most defense trade falls within these industries.

The countries where the percentages of U.S. affiliates subject to performance requirements were highest were India (60%), Libya (58%), Nigeria (52%), Venezuela (52%), Peru (50%), Mexico (41%), Portugal (37%) and Turkey (37%).<sup>4/</sup> The high incidence of less developed countries (LDCs) being successful at imposing performance requirements perhaps can be explained in terms of competition, or lack of it, among industrialized countries seeking access to LDC markets and resources.

As a group, less developed countries generally are insular and often hostile to direct investment from industrialized countries. The latter, on the other hand, want access to

the domestic markets and natural resources of the LDCs. The LDCs may view this as yet another form of economic imperialism or exploitation of the poor and weak by the rich and strong. Polemics and ideology aside, the result is that LDCs have both the inclination--for political, social, economic or ideological reasons, and the leverage--access to their markets and resources, to impose performance requirements on foreign investors.

Conversely, the industrialized countries (with the possible exception of Canada) compete intensively among themselves to obtain direct foreign investment. Many incentives are offered, but fewer performance requirements can be imposed because the potential investor often can secure a better arrangement from another suitor which will choose not to impose performance requirements, or to impose markedly less stringent ones. One notable exception is where U.S. firms invest in order to have access to host government procurement, especially of defense systems and equipment. This is characteristic of the situation in the NATO countries. For the potential investor (say a U.S. firm), the task is to weigh all the good points (including incentives) against the bad ones (including disincentives, such as performance requirements) and to come to a judgment whether a proposed investment--on balance--would be beneficial.

### Transparency, Linkages and Targetting

Another dimension of incentives and disincentives is the question of transparency. Those measures which are explicit and on-the-record can be readily studied. Those measures which are implicit and off-the-record cannot. For example, a U.S. computer firm strapped for cash was able to make a \$50 million investment for \$500,000 cash--a powerful and successful incentive, but explicit and transparent. Another computer company was "incentivized" to make a direct foreign investment in exchange for substantial multi-year sales to the host government once the local plant was established. In this instance there was no transparency and the performance requirement of local investment was linked to access to future government procurement contracts, none of which is on the public record for scrutiny.<sup>5/</sup>

The question of linkages is one of the most difficult to address. In exceptional cases which are documented, countries enter into explicit agreements where the rights and obligations of each party are specified. Customarily, however, linkages are not on the public record and those effected are loathe to discuss such arrangements for fear that the benefits now enjoyed may be withdrawn.

Nevertheless, the existence of such arrangements and their prevalence is widely known. But as every lawyer can testify, knowing something to be true and being able to prove it can be very different matters.

Unlike the U.S., many countries have established industrial policies through which economic development is promoted in target industries. This is the rule rather than the exception. Two industries which have been so targetted by many countries are automobiles and electronics. These industries will be discussed on a case study basis in the following two sections, respectively. The discussion will then turn to NATO co-production arrangements.

### AUTOMOTIVE INDUSTRY CASE STUDY

The automotive industry is the single most studied industry in the context of performance requirements. The reasons are probably threefold: (1) the Mexican automotive decree is highly visible; (2) the investments and trade flows involved cumulatively run into the billions of dollars; and (3) the combination of transparency, large dollar values and limited number of firms involved present an opportunity to try to do a meaningful quantitative analysis of the effects of performance requirements. The political sensitivity of the issue of the export of U.S. jobs and the activism of automotive parts firms and the United Auto Workers (U.A.W.) also likely played a part in the many efforts to analyze the Mexican case.

An October 1981 Department of Commerce study showed that out of 214 U.S. foreign affiliates in the transportation equipment industry, 27 percent were subject to one or more performance requirements. Among the measures identified, 41 countries imposed import restraints, 26 had local

content requirements and 12 imposed minimum export requirements.<sup>6/</sup> One of the most onerous measures in terms of performance requirements is the Mexican Automotive Decree.

The provisions of the Mexican Automotive Decree are complicated, subject to interpretation and change over time. However, the key elements are these: (1) import restrictions, such as an embargo on imports of "luxury" cars and prohibitively high tariffs; (2) minimum domestic content requirements ranging from 50 to 85 percent of the value of each vehicle; (3) minimum export requirements; (4) subsidies to foreign investors who meet certain goals; (5) limitations on foreign equity holdings in Mexican firms; (6) all imports must be financed through exports which generate an equivalent amount of foreign exchange, or more; (7) limitations of royalty payments to parent firms abroad; (8) frequent changes and delays in import licensing and customs clearance procedures; and (9) the near necessity to pay "expediting fees" to Mexican agents to get clearance of goods through customs.

Based on Government of Mexico estimates of future production levels, a cumulative loss of 86,000 to 115,000 jobs from 1979 through 1985 in the U.S. auto and auto

parts industries could occur, according to a private study of the Mexican Automotive Decree. In addition, Chrysler de Mexico is building a plant to produce 200,000 4-cylinder engines annually that, but for the auto decree, probably would have been built in the U.S. Similarly, Ford has a \$375 million engine plant with an annual capacity of 400,000 4-cylinder engines scheduled for completion in Mexico in 1984. Virtually all the production of both plants will be exported, much of it back to the United States.<sup>7/</sup>

As striking as these numbers are, they do not answer the question of what the patterns of trade and investment would have been in the absence of the automotive decree. Estimates of trade and job losses generally are predicated on the assumption that absent the automotive decree, the U.S. would have been able to export to Mexico quantities of vehicles now produced there for domestic consumption or export to third countries. Such assumptions seem naive in the extreme in light of the economic nationalism of Mexico, which is intent on having control of its own economic destiny. It is more realistic to assume that absent performance requirements--which are at the heart of the Mexican decree--that some other trade restrictive measures would have been devised.

Indeed, U.S. automakers apparently are quite pleased and satisfied with their investments. They argue that the U.S. is better off economically than it would have been absent the opportunities for their investments in markets protected from imports. They cite exports of parts and equipment from the U.S., world-wide rationalization of production of autos and parts, and substantial earnings from their overseas investments as evidence of the benefits of their investments. Some U.S. auto parts manufacturers and auto workers understandably take a contrary point of view because of real losses of sales and job opportunities which they believe they would have had absent the automotive decree. This is most evident concerning the new engine plants and in those instances where auto parts previously manufactured in the United States are now produced in Mexico.

The official U.S. Government position is that these and similar industrial programs utilizing performance requirements, of which the Mexican case is thought to be representative, adversely affect U.S. economic interests by inducing direct foreign investment by U.S. parent firms. "This results in a loss of investment, jobs, and capital; fewer U.S. exports to these countries and elsewhere; and increased U.S. imports from these countries."<sup>8/</sup>

The empirical evidence briefly summarized here indicates that performance requirements can indeed have a profound effect on trade and investment patterns. Accordingly, the issue should be pursued to assess how such measures may influence trade and investment in defense systems. The electronics industry will be used as the vehicle for such analysis in the following section.

## ELECTRONICS INDUSTRY CASE STUDY

Performance requirements are a significant element of the equation each firm must consider in deciding whether to try to sell defense electronics in foreign markets. Indeed, some firms have chosen not aggressively to seek NATO contracts because the performance requirements are so severe that it is not profitable to bother.

These are some of the conclusions drawn from a three month study of the defense electronics industry conducted by students of the Industrial College of the Armed Forces. Some 30 plants in eight states and 20 plants in five foreign countries were visited and in-depth discussions held with senior electronics industry officials about, inter alia, their ability to penetrate foreign markets, especially in the NATO countries.

While some firms have walked away, rather than meet foreign performance requirements, most defense electronics firms were found to have taken a more accommodating view.

To the extent that U.S. export control and treaty arrangements allow, most U.S. executives interviewed stated that they cannot sell abroad without local content requirements, countertrade, local assembly and test, offsets, or other such arrangements. Indeed, many executives said that foreign governments often were explicit about their government procurement practices and would state their requirements in tender notices. For example, one tender was reported to have stated that bids would be acceptable only from firms with German names established within the Federal Republic. Canada also was cited as being particularly blatant in this regard.

The Vice-President/International of one of the largest U.S.-based multinational electronics firms stated that contracts are executed which state in detail the rights and obligations of each party, including performance requirements. He stated unequivocally that his firm cannot sell abroad without offsets of some kind. Indeed, his firm maintains an "international bank of accumulated credits" by country to be used as barter whenever his firm wants to make a foreign sale. Saudi Arabia was cited as the only notable exception to these types of practices.

While the majority view was that most performance requirements are overt, many still are covert. Most executives stated that it was common knowledge that one could not sell electronics equipment in Europe, Japan and most other places without meeting certain performance requirements. Accordingly, bid proposals customarily contain proffered offsets, direct investment, use of local materiel, etc. if the bidding firm expects to have its bid seriously considered. It was further generally acknowledged that potential U.S. production and job opportunities are being "exported" as a result of such practices, as the AFL-CIO and individual unions have charged. However, these usually are new jobs generated by increased foreign sales rather than export of existing U.S. jobs.

One executive suggested, however, that the U.S. probably benefits more than the host governments from the imposition of performance requirements. He reasoned that inasmuch as the host government will not permit free trade, it is better for the U.S. firm to be on the inside than the outside. Moreover, once inside, incentives of all kinds including protection from imports from third countries are provided to counter-balance such discentives as performance requirements. The U.S. parent firm usually

gets to export some parts or components from the U.S. and to earn a comfortable return on its investment in a market sheltered from the vicissitudes of international competition. It is noteworthy that similar arguments have been offered by U.S. automakers with respect to the benefits of the Mexican Automotive Decree.

In this regard, it is noteworthy that Mexico has selected the computer industry as its next target. A new Computer Decree has been developed which, like autos, links performance requirements to incentives. The requirements include limiting foreign investor equity participation to not more than 49 percent, job creation, minimum export requirements and the progressive imposition of more stringent import restraints. The likely impacts on the U.S. are clear: job opportunities which are or would have been available in the U.S., but for the Computer Decree, will be "exported" to Mexico; U.S. competitiveness in the face of heavily subsidized Mexican production will decline with subsequent losses of exports, either as a result of not being price competitive, or of import restraints, or both; and losses will occur of exports to third country markets in which the U.S. will have to compete in out-years with subsidized Mexican production.<sup>9/</sup>

Korea has embarked on a similar project. New import regulations have been promulgated to control imports of mini, micro and personal computers, peripherals and parts. Permission to import medium and large computers will be linked to technology transfer to Korea. The potential losses to such firms as WANG are great, but even IBM is threatened with loss of its markets unless it establishes technology related production facilities in Korea.10/

Brazil and Spain also impose performance requirements to achieve similar goals. Many other countries, notably Singapore, Malaysia, Hong Kong and Taiwan, provide incentives to encourage direct foreign investment and technology transfer. Indeed, just as the existence of a domestic steel industry was once a symbol of industrial growth and national pride, the creation of an electronics industry now represents a sort of rite-of-passage into the technological era: every country has to have one to assert its national stature and pride.

It is common knowledge and conventional wisdom that many U.S. firms have transferred technology and established electronics assembly operations abroad. While this generalization has some applicability to commercial and

consumer electronics, it is not true with respect to defense electronics. The facts are that only modest amounts of conventional technologies have been transferred abroad, that component manufacture remains in the United States, and that off-shore operations are almost exclusively limited to assembly, test and packaging of off-the-shelf products such as printed circuit boards. Electronic components, sub-assemblies and other articles produced to military specifications are all produced in the United States.

Whether and to what extent the imposition of performance requirements has played a role in off-shore production of commercial and consumer electronics products and in assembly of U.S. off-the-shelf electronic components is unclear. To date it appears likely that U.S. commercial electronics firms have willingly moved off-shore in response to substantially lower labor costs, financial and other incentives, and access to local markets. A foothold in an electronics market of the future could be intelligent corporate strategy, especially when coupled in the near term with lower labor costs and government subsidies providing immediate benefits.

From the available studies of the electronics industry it appears clear: that most defense systems contain electronic components; that the application of performance requirements by foreign governments to defense electronics--and by implication to all defense trade--is pervasive; that performance requirements play a profound role in determining trade and investment patterns; and that the concept of an open marketplace for defense trade is non-existent. The President and the Congress have recognized these facts and have proposed a new multilateral framework for NATO co-production arrangements. This initiative and its relationship to performance requirements will be discussed in the next section.

### NATO CO-PRODUCTION ARRANGEMENTS

An issue closely related to performance requirements is that of co-production arrangements between and among the member countries of the North Atlantic Treaty Organization (NATO) and potentially with other allies such as Japan. U.S. policy concerning NATO arrangements is laid down in the so-called Roth-Glenn-Nunn Amendment to the 1983 Department of Defense Authorization (S. 2248). That amendment expressed the sense of Congress, which subsequently was presented to the NATO countries by the President as U.S. policy, that the NATO allies should:

- (A) pool their defense efforts and resources to create, at acceptable costs, a credible, collective conventional force for the defense of the North Atlantic Treaty area;
- (B) establish a cooperative defense-industrial effort within Western Europe and between Western Europe and North America that would ultimately reduce the otherwise necessary defense costs of the United States and other NATO countries, by providing a larger production base while eliminating unnecessary duplication of defense-industrial efforts;

- (C) share, equitably and efficiently, the financial burdens, as well as the economic benefits, including jobs, technology, and trade, of NATO defense; and
- (D) begin negotiations promptly to establish the strategies, structures, policies, and programs to give full effect to the agreements described in clauses (A) through (C).<sup>11/</sup>

This statement of policy is intended, inter alia, to expand existing bilateral and plurilateral NATO co-production arrangements into a multilateral framework. The current vehicle is so-called Memoranda of Understanding (MOUs) which are negotiated between two or more NATO allies to develop cooperatively and/or manufacture various military systems necessary for NATO defense. To the extent that a new multilateral framework were negotiated, it could render moot the question of performance requirements otherwise applicable to trade and investments in defense systems.

Before going on to explore the implications of co-production arrangements vis-a-vis performance requirements, some further explanation of the genesis of this new policy may help to put the issues and their inter-relationships in perspective.

The United States consistently has run a balance-of-trade surplus with its NATO allies in defense goods of about 6:1.<sup>12/</sup> Coupled with consistent and substantial balance-of-trade surpluses in the commercial sector with these same countries, inevitable political pressures have arisen.

NATO defense is perceived to be of significant economic benefit to the U.S. but to no one else. The so-called "two-way street" is considered to be a bad joke and is the subject of political cartoons in Europe. The situation has become politically explosive and our NATO allies increasingly are using performance requirements and other devices to try to keep matters from getting worse, if not to reverse the trend itself. The policy set forth in the Roth-Glenn-Nunn Amendment, and the specific reference to sharing "the economic benefits, including jobs, technology, and trade, of NATO defense", is a response to this situation.

There also are several other driving forces behind the new co-production policy. First, the cost of defense is large and growing and resources are always inadequate to meet perceived needs. Where our allies have lower production costs, co-production can result in greater efficiency,

thereby yielding more defense for each dollar spent. By definition co-production also means ready access to a second source, a usually effective wedge to assure that defense procurements are obtained at the lowest possible cost.

Second, in many instances our allies have developed, or have the capability to develop and manufacture, defense systems better designed to meet U.S. specifications than U.S. industry can offer. In such instances, co-production may mean technology transfer to the U.S., lower costs, shorter lead times and greater force effectiveness.

Third, many observers detect a waning of allied interest in NATO defense arrangements for a variety of reasons, such as domestic political dissidence opposed to defense expenditures (for whatever reasons), fear of nuclear war, and unhappiness over the economic imbalance in defense trade. While co-production cannot solve the social and moral issues, it can help to distribute the economic benefits of military industrial production more equitably and, thereby, defuse some of the political issues.

Fourth, part of the current unrest in the alliance can be traced to a sense of a lack of participation and purpose. The United States forces and commitment are so large

compared to any individual ally that each is dwarfed by comparison. This coupled with large trade deficits with the U.S. has fostered a natural resentment, inclination to go-it-alone and disinclination to contribute their "fair share" of collective defense efforts and costs (as perceived by the U.S.). Co-production would contribute to building a mutual sense of purpose and commitment.

Finally, co-production is desirable on purely defense grounds because it would foster the NATO goals of rationalization, standardization and interoperability. In so doing a more effective fighting force could be forged. At present many allies have different command, control and communications systems, which means they have limited or no ability to communicate with each other in the event of hostilities. Similarly, the proliferation of different weapons systems and munitions means that the allies have limited or no capacity to be mutually supportive in provision of maintenance, repair, spares, transportation or ammunition. If one country needs supplies or technical assistance, another is unlikely to be capable of providing it.

Instead of one integrated fighting force, there are as many forces as there are countries. Moreover, the army, navy and air forces of individual countries often do not

have the capability to communicate with each other, never mind communicate with the forces of another country, because their communications equipment is incompatible. Co-production is one way to promote rationalization, standardization and interoperability and, thereby, to forge a more effective fighting force.

While trade in commercial goods is subject to many restrictive measures imposed by governments, the trade in defense systems is even worse. The various GATT agreements, for example, often explicitly exclude defense trade from their provisions, as is the case with the GATT Government Procurement Agreement. Adding to the aura of transactions separate-and-apart from commercial trade is the fact that most governments keep separate, classified statistics on defense trade.

It is perhaps little wonder then that a no-holds-barred atmosphere seems to prevail in defense trade. Most international transactions appear to be negotiated and the concept of a free market place is all but nonexistent. In this climate performance requirements have a natural home and have become pervasive. The examples of performance requirements cited in the electronics case study appear to apply broadly throughout defense electronics procurements

abroad. Moreover, electronics is thought to be illustrative of defense trade generally because most defense systems contain electronic components or sub-systems.

In recognition of the many costs of the current systems of defense procurements, and of the potential benefits to be derived by all the NATO countries from a change in policy, the Congress and the President fashioned the co-production initiative presented by the President to NATO in 1982. The intent is to try to create a multilateral market place for defense trade for all the reasons cited above. If this initiative were to lead to a "Tokyo Round for defense trade," as some Members of Congress hope, then the plethora of performance requirements and other measures used to restrict defense trade would be brought under greater international discipline.

Regrettably, the outlook for the U.S. initiative is not good. Our NATO allies greeted it with suspicion and distrust, in no small part because the U.S. has a less than stellar performance record of failing to live up to existing Memoranda of Understanding and of Buying American even when an apparently superior European defense system

is readily available. If the U.S. cannot honor bilateral agreements, why should it be trusted to honor multilateral ones.

Moreover, even though some allies may be prepared to accept the President's offer as genuine, there is a widespread belief that the issue is outside the President's control. The President may propose, but the Congress will dispose. And the Congress is seen as protectionist in the extreme. The critical materials clause and other Buy American provisions of the various defense authorization and appropriations bills are cited as evidence. Senators Roth, Glenn and Nunn explicitly recognized this credibility problem in presenting their amendment to the 1983 Defense Authorization Act. In response to their appeal that the Congress send a message to our allies, the Senate voted 87-to-1 for the amendment.

That legislative feat notwithstanding, our allies have taken a wait-and-see attitude. Meanwhile, the U.S. apparently has not followed through on the initiative. It appears to be laying on the NATO table unattended where it is likely to die unless the U.S. makes a concerted effort to demonstrate that the offer is both genuine and viable. Meanwhile, this writer was told by various executives of

European electronics firms that the world is out throughout NATO; buy any defense system except American. When it cannot be avoided, impose sufficient performance requirements to assure maximum European participation through local production, offsets, etc.

One three-star general at SHAPE headquarters opined that the co-production proposal is one of the best initiatives in recent years to promote NATO objectives. He fears, however, that the initiative will die for lack of attention on both sides of the Atlantic. The Departments of Defense, Commerce and State and the U.S. Trade Representative should follow through in a coordinated effort to try to convince our NATO allies that the offer is both genuine and viable. Both formal and informal representations should be made. Bilateral consultations and the various NATO committees are the proper places to begin.

The President was charged by the Congress to "begin negotiations promptly to establish the strategies, structures, policies, and programs to give full effect to the agreements described..." by the Congress. Having worked out the parameters of such a negotiation, the President is to return to the Congress to seek the appropriate legislative mandate. The Trade Act of 1974,

which delegated to the President sufficient authority to begin the Tokyo Round of Multilateral Trade Negotiations, is illustrative of the sort of authority to be sought on defense trade and the process to be followed.

While co-production may not be a solution to the whole problem of performance requirements, such agreements could alleviate a significant portion of the problem as it is relates to government procurement of defense systems by our NATO allies. Moreover, what is good for NATO today could be expanded to cover other treaty relationships tomorrow--notably Japan.

Solutions to whole problems are seldom feasible at one stroke. Partial solutions, however, can provide a base on which to build toward broader solutions. NATO co-production agreements executed within a multilateral framework would be such a beginning. It is a way to begin a process of moving away from parochial and short-sighted protectionism toward a freer, more open marketplace for defense trade--at least among the NATO allies.

Negotiations should be pursued with vigor. Only by such means can the deleterious effects of performance requirements be overcome to the benefit of all.

The most obvious place to begin is with a comprehensive review of the NATO Government Procurement Agreement to determine which provisions would be applicable to defense trade. Consideration also would be necessary of any special provisions needed to deal with the concept of co-production and with the protection of necessary national security interests.

It would be wise at the outset to invite Japan to participate, if possible. If not, then perhaps observer status could be offered, or regular bilateral consultations held, as a way to engage Japan in the same process. Only by bringing such non-NATO allies into the process early and often can the U.S. hope to extend the concept of a government procurement code for defense trade beyond the NATO co-production concept.

## CONCLUSIONS AND RECOMMENDATIONS

### Conclusions

1. Trade-related performance requirements distort international trade and investment patterns.
2. Trade is distorted directly by minimum export requirements, import restrictions and similar measures which impose artificial stimuli or restraints on the free flow of goods and services.
3. Trade is distorted indirectly by the alteration of patterns of investment from those that would have prevailed in an open environment where the law of comparative advantage could function.
4. Investment is distorted because entry into particular markets has been conditioned on and "sold" in exchange for a firm's willingness to meet specified performance requirements.
5. The incidence of performance requirements is wide-spread, affects many industries, is common among both developed and developing countries, and is growing.
6. While some arrangements involving performance requirements are transparent, many are not.
7. Linkages between the provision of incentives and performance requirements are common to most countries.
8. Most countries other than the U.S. have industrial policies or other national planning mechanisms through which selected industries are targetted for development. The automotive and electronics industries are among those targetted by many countries.

9. Empirical evidence as to the economic effects of performance requirements usually does not exist because of a dearth of data, often resulting from a lack of transparency.
10. The Mexican Automotive Decree is a notable exception to the customary lack of transparency and is one of the most onerous examples of the imposition of performance requirements.
11. One study estimates a cumulative loss of 86,000 to 115,000 U.S. jobs from 1979-85 in the U.S. auto and auto parts industries as a result of the Mexican Automotive Decree.
12. In studies of the defense electronics and computer industries, performance requirements have been shown to be a significant factor which business executives must consider in deciding whether to try to penetrate most foreign markets.
13. Most electronics industry executives interviewed in one study stated unequivocally that they could not sell in NATO and other countries unless they met certain performance requirements.
14. Some U.S. firms have withdrawn from attempts to make sales in particular markets because the performance requirements were considered to be too onerous.
15. Many electronics industry executives have acknowledged the charges of the AFL-CIO and others that performance requirements do indeed result in the export of U.S. production and job opportunities. However, these are usually new opportunities arising from increased foreign sales rather than the export of existing U.S. jobs.
16. Some electronics industry executives have suggested that the U.S. usually realizes a net gain from performance requirements because access is gained to otherwise protected foreign markets and to lucrative government procurement contracts. This argument is similar to the one made by U.S. automotive firms which have invested in Mexico.

17. These positive reports notwithstanding, Mexico, Brazil, Korea, Spain and many other countries have targeted the computer industry for local development, and performance requirements threaten existing and potentially lucrative U.S. export sales.
18. U.S. producers of commercial and consumer electronics products have transferred technology and established production facilities abroad. Manufacture of defense systems, sub-assemblies and electronic components built to military specifications all remains in the United States.
19. U.S. direct foreign investment in the commercial electronics industry appears to have willingly moved off-shore in response to such incentives as lower labor costs, subsidies and future market development prospects, rather than in response to disincentives such as performance requirements.
20. Available evidence clearly indicates: that most defense systems have electronic components; that the application of performance requirements to defense electronics--and by implication to all defense trade--is pervasive; that performance requirements play a profound role in determining trade and investment patterns; and that the concept of an open market in defense trade is non-existent.
21. Performance requirements are utilized by the NATO countries to try to hold the line against massive military trade deficits with the U.S., if not reverse the trend.
22. NATO co-production arrangements are closely related to performance requirements and can where successfully applied render the latter moot.
23. Co-production is a short-hand expression for open competitive bidding for defense contracts among NATO defense contractors, often with resulting development and production contracts to be shared among various countries and with production in more than one country.
24. U.S. policy is to expand existing bilateral and plurilateral co-production arrangements into a multilateral framework under NATO.

25. Co-production is part of an overall NATO strategy of rationalization, standardization and interoperability that can result in an expanded mobilization base, more effective fighting forces, more efficient utilization of scarce defense dollars, greater mutual commitment to the concept of collective defense, and more equitable distribution of the economic benefits of military industrial production.
26. Absent this or some other initiative to address directly the legitimate grievances of our NATO allies and to defuse a highly charged political situation, NATO alliance cohesion and effectiveness will continue to suffer.
27. The Congress has charged the President to pursue multilateral negotiations among the NATO countries to make U.S. policy of co-production a reality. Successfully pursued, this initiative could lead to a "Tokyo Round for defense trade."
28. The President has presented this position to NATO, but initial reactions were negative and marked by suspicion and distrust of U.S. motives. The initiative lays unattended on the NATO table where it is likely to die unless NATO can be convinced that the offer is both genuine and viable.

#### Recommendations

1. The Departments of Defense, Commerce and State and the U.S. Trade Representative should begin an active campaign to convince the NATO allies that the U.S. offer to negotiate a multilateral framework for open and competitive bidding on defense procurement among the NATO allies is both genuine and viable. Bilateral representations and the various NATO committees should be used to press the U.S. position.
2. Initial U.S. efforts should be focused on the GATT Government Procurement Agreement to determine if it could serve as a model for, and which provisions would be applicable to, an agreement on defense systems procurement. Additional provisions presumably would be necessary to provide for the concept of co-production and for protection of national security interests. An agreement separate and apart from the GATT probably would be necessary.

3. Special arrangements should be worked out to permit Japan to participate in the NATO process, or the U.S. should conduct parallel bilateral consultations. Only by involving non-NATO allies early and often can the U.S. hope to extend the concept of a multilateral code-of-conduct for defense trade beyond NATO.
4. This process should be moved forward into a pre-negotiating situation as quickly as possible. Once the parameters of a negotiation can be established, legislation should be drafted in concert with appropriate Congressional committees to delegate to the President sufficient authority to conduct such negotiations.
5. Even before legislation is enacted, but once the parameters of it are laid out, active negotiations should begin to make the U.S. multilateral co-production policy a NATO-wide reality. An ad hoc NATO negotiating committee may have to be established to provide the constant attention and focus that such negotiations will require.
6. Consultations will need to be held with industry, labor and other private sector interests to secure their advice on and support for U.S. negotiating objectives. Existing federal advisory committees should be reviewed to determine whether existing committees and their charters provide a ready-made vehicle for conducting such consultations. Otherwise, charters may have to be revised or new committees created.
7. Multilateral co-production negotiations will represent a major undertaking necessitating the provision of adequate agency resources. The assignment of basic responsibility should be clear-cut and appropriate recruiting begun, as necessary, to secure the skilled personnel necessary to such an undertaking.
8. An appropriate interagency committee will need to be tasked to coordinate Executive Branch efforts in support of such negotiations.
9. The detailed actions and activities necessary to conduct a successful negotiation are many, varied and inappropriate to elaborate here. The point is that the process is long, complex and demanding. It needs to begin immediately.

10. An agreement on a government procurement agreement for defense trade is not a whole solution to the problem of protectionism and performance requirements, but it would be a major step away from the pursuit of narrow, parochial interests toward freer trade in defense systems.
11. NATO co-production is a win-win strategy for greater NATO cohesion and effectiveness warranting full and active support. The President and the Congress have set the policy direction. It is now incumbent upon the Executive Branch agencies--principally the U.S. Trade Representative and DOD--to make that policy become a reality. Bureaucratic inaction could kill it. Enlightened leadership could make it a reality.

FOOTNOTES

1. USA-BIAC, Relationship of Incentives and Disincentives to International Investment Decisions, (New York: September 1981), p. 30.
2. Data derived from the 1977 Benchmark Survey as quoted in U.S. Department of Commerce, The Use of Investment Incentives and Performance Requirements by Foreign Governments, (Washington: October 1981), pp. 7-8.
3. Ibid, pp. 9-12 and 17.
4. Ibid, pp. 12-15.
5. Source has declined to be identified.
6. U.S. Trade Representative, U.S. Submission in Response to OECD Document DAFFE 82.26, Annex II: Trade-Related Investment Measures. (Washington: January 1983), pp. 10-12.
7. Ibid, p. 13
8. Ibid, p. 19.
9. Ibid, pp. 20-21.
10. Ibid, pp. 21-22.
11. Congressional Record, May 13, 1982, p. 55045.
12. Ibid.

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